Moscow Financial Weekly

For the week ending June 7 and 14 and 21, 2002
Treasury Attache's office, US Embassy Moscow

Highlights
- CBR clarifies bank reform plans
- Capital account turns postive

Weekly focus: 2003 Draft Budget assumptions

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/$ (MICEX) UTS	R31.3965	0.00	4.18
Monetary Base*	R780.6 bln	2.20	10.18**
CPI	NA	NA	8.5
International Reserves*	$42.5 bln	0.47	16.44
RTS Index (end of week)	349.22	-7.77	34.29
Refinancing rate	23	0	4

*For week prior
**** % chg from the abnormally high seasonal level at the end of the year.**

Economic Developments

The Tax Ministry reported **R117.5 billion ($3.75 billion) in tax collections in May**. This is R3.3 billion ($105 million) or 2.7% short of the targeted collections. However, due to strong collections in the first quarter of the year, the total amount collected for the year to date was $370 million over budget. More worrisome is the situation in the regions. Corporate tax revenues are down because many regions are choosing to forego the 4% of the 24% of the profit tax allocated to them, since they are allowed to exempt companies from payment.

Not surprisingly, according to Finance Ministry data, the **federal budget recorded a deficit of R31.9 billion in May**; however the budget is still in surplus for the year to date, albeit at lower levels, dropping from R82.9 billion in January to R52.9 billion in May 2002. The latest deficit is due to transfers to the region for state employee vacation bonuses. The GOR is planning to allocate an additional $1.25 billion to regional budgets for this year, to cover the increase cost of state salaries to employees, including judges and the military. These increases are expected to be covered at the federal level by lower interest payments on debt and some of the R68 billion in extra spending built into the budget (see focus article).

The trade surplus increased to $16.9 billion during the first 4 months of the year (18.7% lower y-o-y). During the first quarter of 2002 the surplus stood at $12 billion. CBR data indicates that exports grew in April to $9.0 billion -- 4.4% higher m-o-m and 3% y-o-y -- the first time a positive y-o-y change in exports has been recorded in over 8 months, due to the firming of oil prices. Imports grew slightly in April, totaling $4.9 billion vs $4.7 billion in March.

On June 18, the **GOR announced that it would issue up to $700 million worth of 2010 and 2030 Eurobonds** in order to restructure its debt to the International Investment Bank and the International Bank for Economic Cooperation, which total about $1.2 billion. These debts represent Soviet-era trade credits, and the GOR plans to apply London Club terms (37% reduction in principal and 33% reduction in accumulated interest). As this was expected, markets were not impacted.

Goskomstat reported that **Russian GDP grew by 3.7% y-o-y in the first quarter of 2002,** an upward revision from preliminary data (3.3%). This is lower than the 4.8% rate during the same period last year, and the lowest reading since the second quarter of 1999. However, this figure is broadly in line with projections, barring any further slowdowns this year.

Industrial production was 3% y-o-y during the first 5 months of the year down from 5.9% last year. Metals, food and drugs were the growth leaders while manufacturing was essentially flat. Seasonally adjusted, May growth was 4.4% y-o-y vs. 1.2% in April indicating a possible upward trend. Less promising is recent data showing that corporate profits have fallen by nearly half y-o-y in the first four months of 2003. This would indicate that firms are being slow to improve productivity to counter an appreciating ruble.

Banking sector

According to preliminary CBR estimates, **the inflow of capital to Russia**, as recorded in the capital account of the balance of payments, reached $1 billion in Q1 2002. This is the first time a net inflow was registered in the history of new Russia, CBR First Deputy Chairman Oleg Vyugin said.

On May 11 the Supervisory Board of **Vneshtorgbank (VTB)** in a unanimous vote replaced Yuri Ponomarev as the President and Board Chairman of the bank by Andrei Kostin, Chairman of Vnesheconombank (VEB). The next day President Putin relieved Andrei Kostin from the post of VEB Chairman and appointed to that post Deputy Finance Minister Vladimir Chernukhin. The government retracted previous statements supporting the merger of the commercial side of VEB with VTB, though Kostin continues to claim publicly that the deal is still on.

On June 5 the State Duma passed in third reading the controversial amendments to the **Law on the Central Bank**. However, just few days later, on June 14, the Federation Council turned down the bill and proposed to form a conciliatory commission to discuss, primarily, the issue of limiting the number of inspections the CBR would be allowed to do in any given bank within a single year. The Council agreed that such limits to inspections violated Basel standards. Revisions to the bill will be considered on June 27th and possibly finalized before the Duma recess.

On June 18 the Congress of the **Association of Russian Banks** (ARB) by overwhelming majority vote approved the decision of the ARB Council of May 30 to replace Sergey Yegorov at the post of ARB President with Garegin Tosunian who had been First Vice President of the ARB since 1994. The newly elected President told the Congress that ARB should get the status of self-regulating organization and be represented in the National Banking Council.

Over 90% of Russian banks are financially sound, said Andrei Kozlov in his presentation at the International Banking Congress (IBC) that took place in St. Petersburg on June 6-7. In 2001 bank assets grew at 3 times the pace of GDP, Kozlov said. As of April 2001, banks had private deposits worth 7.4% of GDP and had invested resources worth 7.6% of GDP into the real sector. The Russian banking system has started to perform the function of financial intermediary, Kozlov concluded, but still "specializes in reallocation of incomes and flight movement of capital instead of transformation of savings." He added that funds kept by Russian banks abroad are worth 2.2% of GDP.

According to Andrei Kozlov, by the end of this year the **CBR will develop diagnostic criteria for banks**. Banks that have passed the diagnostic review will be permitted to join the system of deposit guarantees beginning in 2003. The CBR has already created the Main Inspection Board that will do respective diagnostic testing. Kozlov added that starting from January 1, 2003 new licenses would not be issued for banks that have not applied to enter the system of deposit guarantees. Existing banks will be given a 6-month grace period to apply. By 2004 all banks, no matter whether they have applied or not, will be checked for compliance with the deposit guarantees criteria. Those who failed to pass the test will lose their licenses to work with private deposits.

Soon the CBR may adopt the **IMF Special Data Dissemination Standard** (SDDS) for reporting on international reserves and foreign currency liquidity, Nadezhda Ivanova, Director of the CBR General Economic Department, said. Economic security considerations had prevented Russia from SDDS reporting, Ivanova explained, "but today the volume of reserves accumulated allow CBR to start publishing the data".

The Central Bank announced on June 19 that **exporters can now sell hard currency export earnings through authorized banks**. Previously, the Central Bank required exporters to sell 50% of their export earnings to only the Central Bank or MICEX. Now, exporters may sell to 18 pre-authorized banks. Vuygin claims that the new rule will make it easier for the CBR to intervene in currency markets and will boost liquidity and stability. Increasing the pool of participants could force down commissions as well. However, Vuygin pointed out that this decision was not a result of a recent Supreme Court decision ordering the CBR to allow other banks to participate. Vuygin claims that the CBR has the authority to issue procedures for export revenue sales and the right to limit sales through dealers of its choosing. This marks a small step towards liberalization in the currency market.

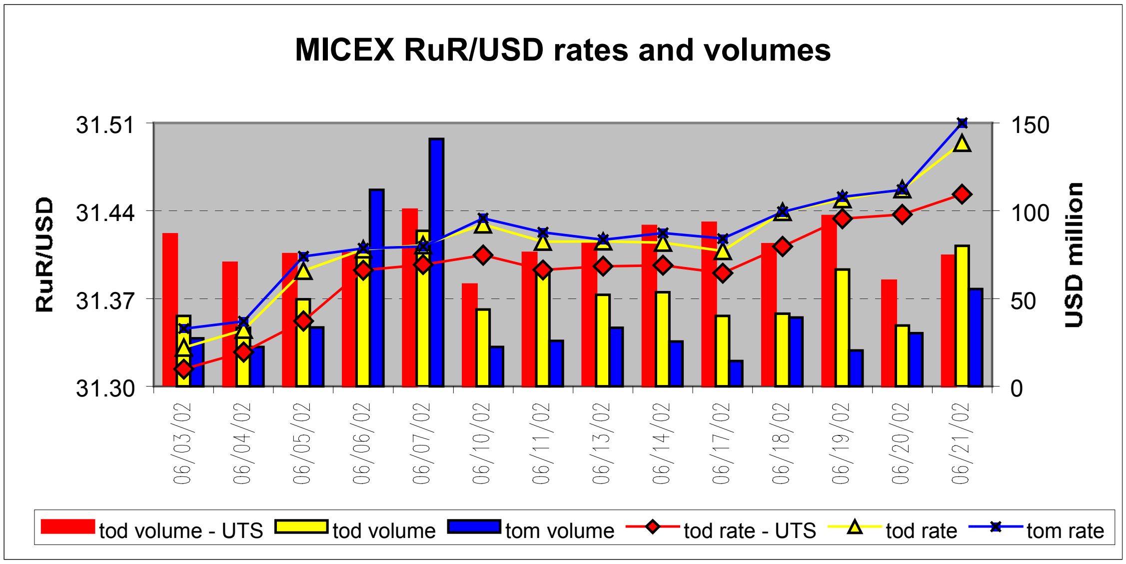
Vyugin also said that by the end of the year the ruble would go down to R33/$. Surprisingly, this forecast puts the ruble well below its current December futures price at CME.

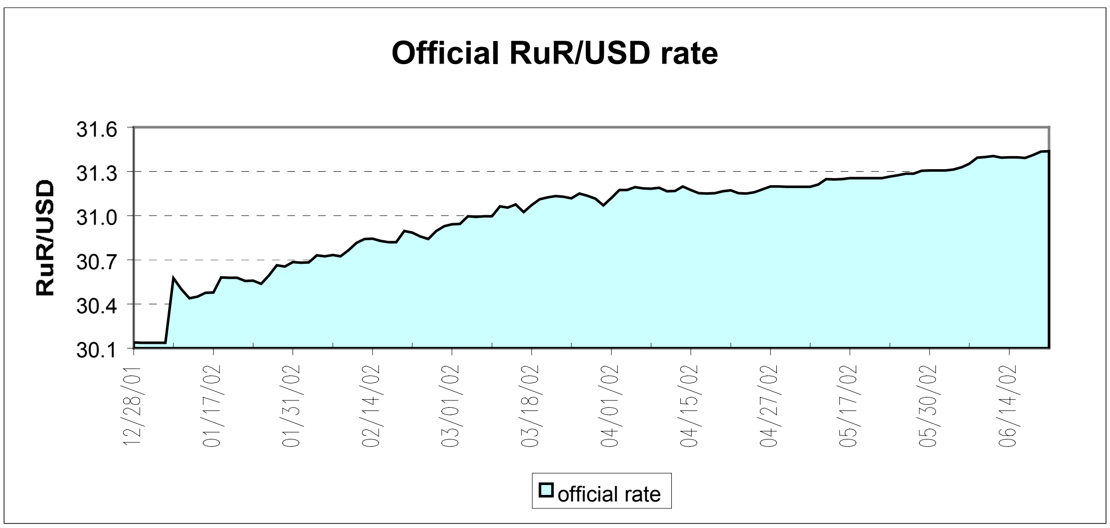
Financial markets

Forex Market

On the first week of June the forex market perked up after a longer period of lull. This may be attributed to a number of factors: significant increase of the sum of balances in correspondent accounts with the CBR (on June 3 it for the first time since the first week of the year they went over R100 billion), a cut of the CBR short-term deposit rates and, possibly, some decline in export revenues, though accelerating inflation is likely the main factor. MICEX trading, volume-wise, shifted from the morning session where the CBR had lately ruled, to the afternoon, where CBR's presence had not been observed. On the afternoon of Friday, June 7, the CBR was even selling dollars instead of buying, as had been the case in the previous weeks. However the next week, with balances in correspondent accounts with the CBR falling and dates for mandatory payments for banks approaching, the market went dull again. After June 12, a Russian holiday, the CBR had to tighten control of the market, intervening on both ends. Last week the ruble, after appreciating 0.02% on Monday, resumed weakening against the dollar rather rapidly on the background of low interbank ruble loan rates. The CBR did not attempt to support the ruble. On Friday afternoon with the securities market falling the ruble went below the R31.5/$ benchmark.

For the week of June 3 the ruble weakened against the dollar 0.29% in nominal terms, closing in the UTS on Friday at R31.3970/$. MICEX weekly trade volumes were $408.63 million, $285.67 million and $335.93 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively. For the week of June 10 the ruble remained practically unchanged against the dollar (R31.3965/$), with MICEX weekly trade volumes at $306.66 million, $213.62 million and $107.14 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively. For the week of June 17 the ruble weakened 0.18% against the dollar, closing in the UTS on Friday at R31.4531/$. MICEX weekly trade volumes were $405.51 million, $261.49 million and $159.55 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively.

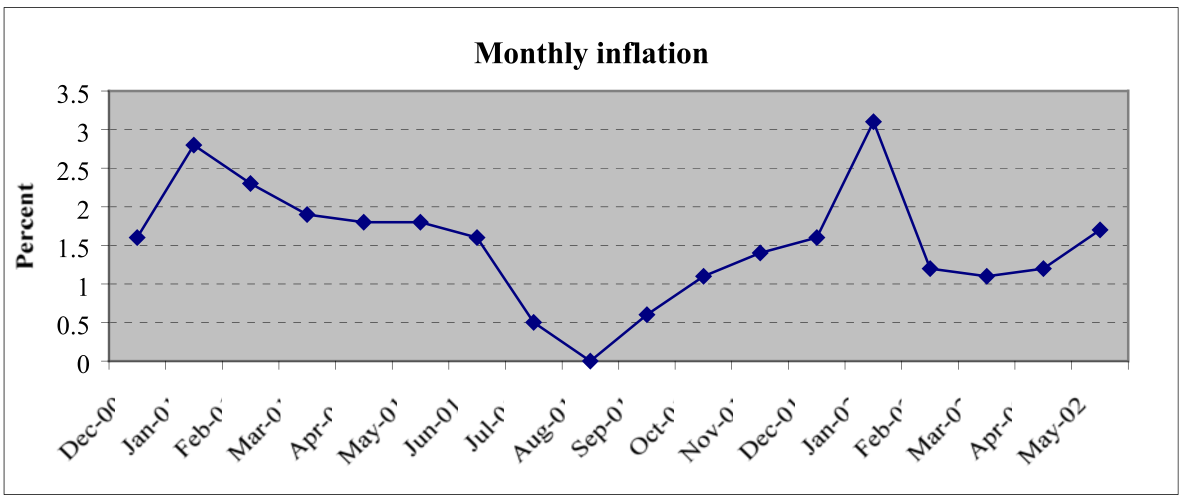




Prices

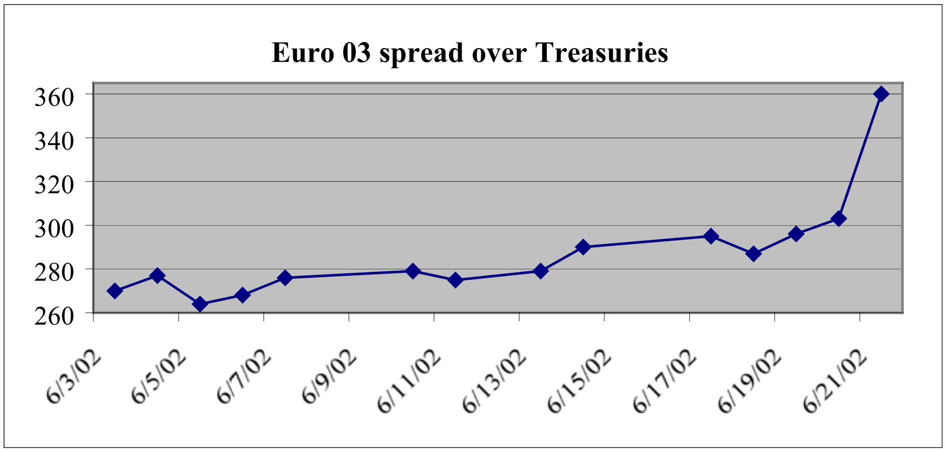
According to Goskomstat, the inflation rate in May increased to 1.7% from 1.2% in April. For the year, inflation stands at 8.3%. The daily inflation increased to 0.054% in May from 0.038% in April. The main cause of the increased price growth was the seasonal spike in prices of foodstuffs (2.2%), as well as increased tariffs in the from the beginning of the year. This last factor affected the PPI in April and later on hit consumer prices as well. May inflation corresponds to 16% annual growth rate.

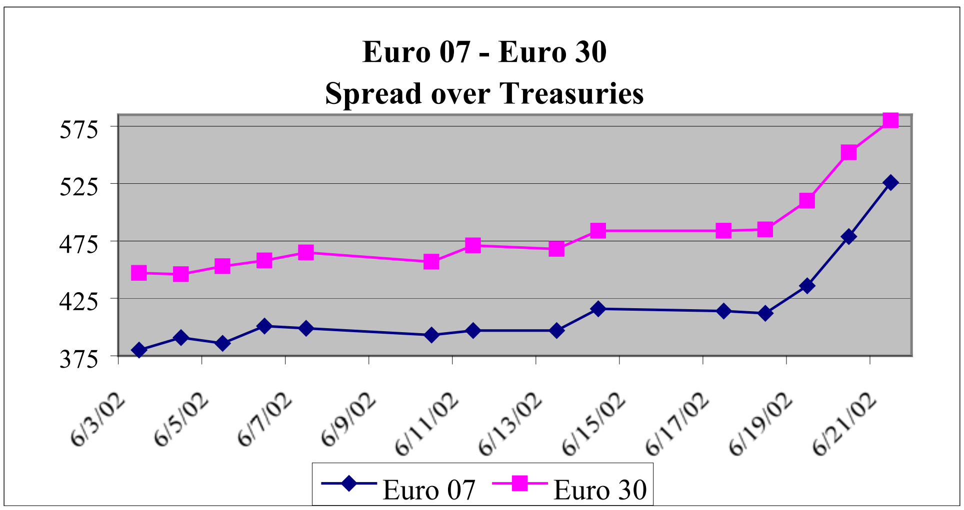
Inflation during the first 17 days of June was 0.5% which corresponds to 0.8% inflation rate for the month. This is a considerable slow-down compared to May. Summer months are traditionally periods of lower inflation; however, petrodollars and the corresponding ruble issuance by the CBR might preclude a dip similar to last year's.



Eurobonds

The overall trend on the Russian Eurobonds market was negative during the last three weeks. Selling was initiated based on external news primarily from Brazil rather than Russian fundamentals. The prices of Russian bonds were trading at close to historic highs and, therefore, are very sensitive to developing market news.

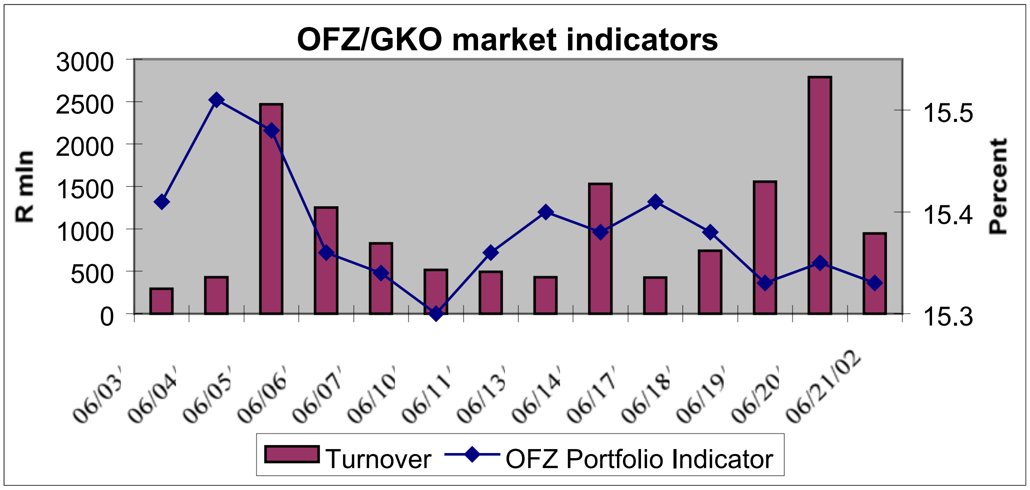




<u>Interest/Bond Market</u>

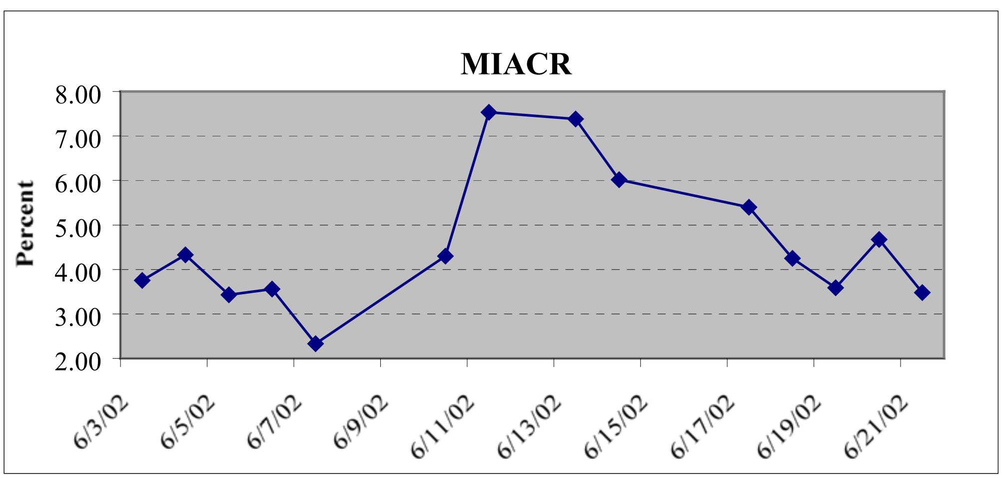
Bonds/Bills

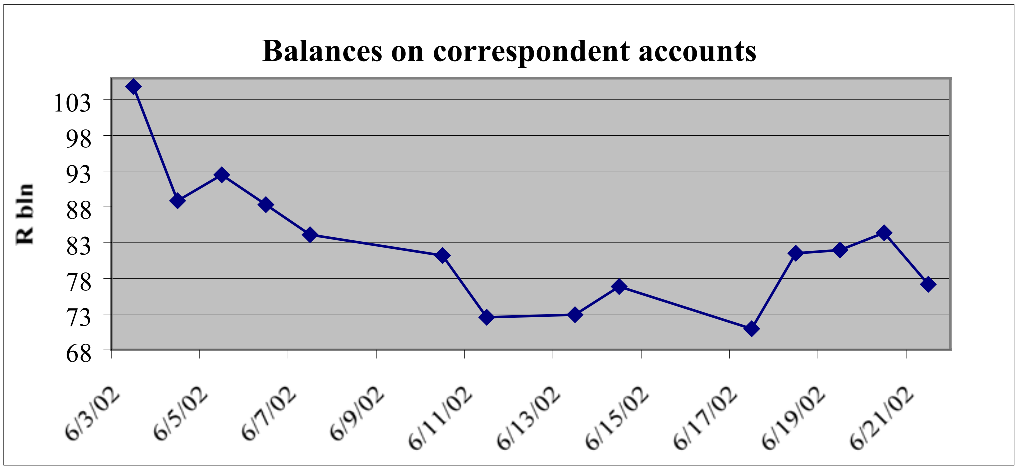
High ruble liquidity had a major effect on the secondary OFZ/GKO market during the first week of June. Later on in the week, the proceeds from the OFZ redemptions were reinvested in the market, giving prices an additional upward push. The lack of attractive ruble instruments forced market players to purchase government debt, even at very low yields. Trading activity remained on moderate levels during the week. Next week the market experienced downward price corrections, explained by banks' demand for rubles in expectation of VAT payments. Trading activity remained below average. Last week trade volumes increased substantially, with 65% of activity explained by the additional placement of long-term OFZs with the Pension Fund. The rest of the market was fluctuating without any clear-cut trend throughout the week.



Overnight rates

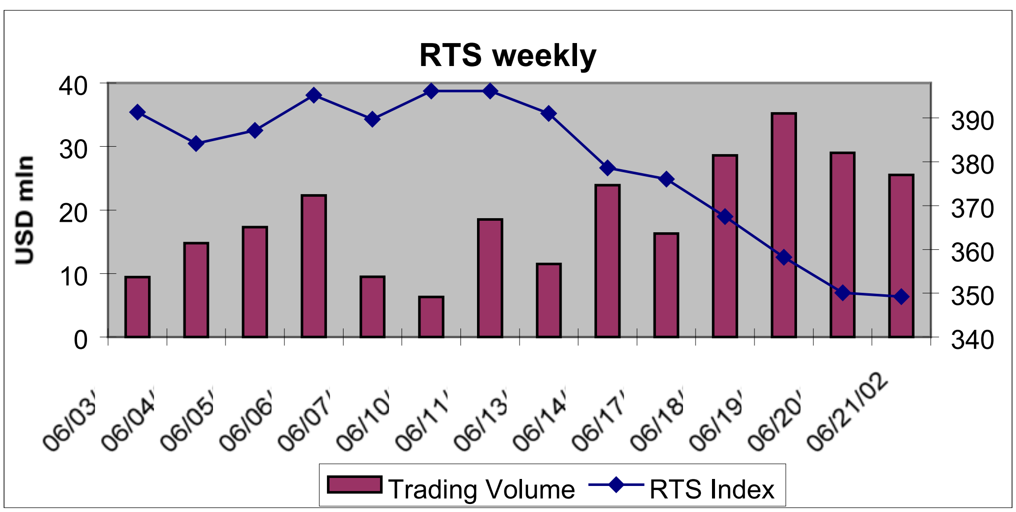
The market was flooded with rubles during the first week of June, and short-term interbank ruble loan rates dropped to 2.33% p.a. (MIACR) at the end of the week. At the same time, the CBR lowered the overnight deposit rate by 100 bps down to 3% p.a. Balances on banks' correspondent accounts at the CBR were quite high throughout the week. The situation reversed during the next week due to obligatory tax payments in the middle of the month. Banks were scrambling for rubles with the overnight rates going up to 7-8% p.a. range. Balances on banks' correspondent accounts were below R80 billion almost all week. Last week, ruble liquidity improved and balances got back to their average levels (R80-85 billion). Overnight rates reacted by falling and on average didn't exceed 5% p.a. during the week.

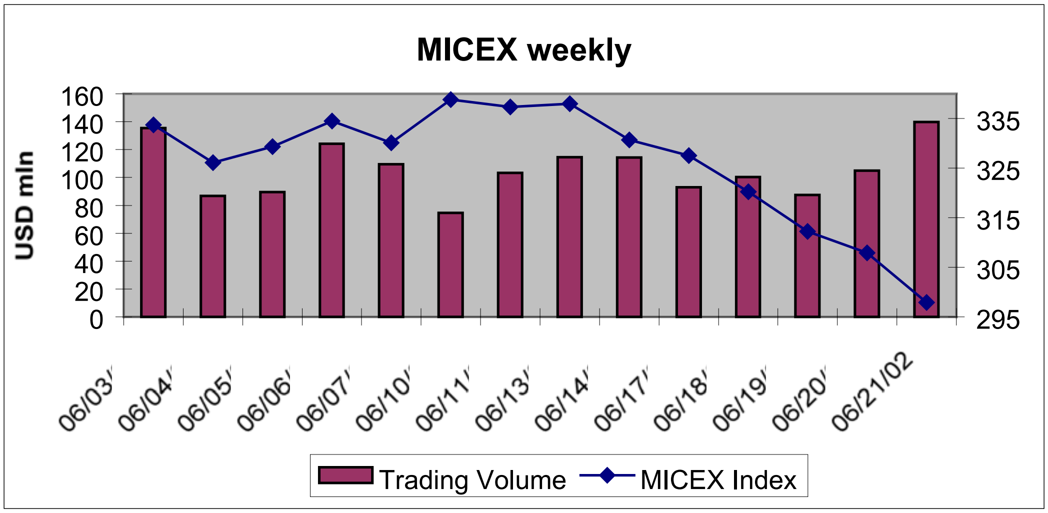


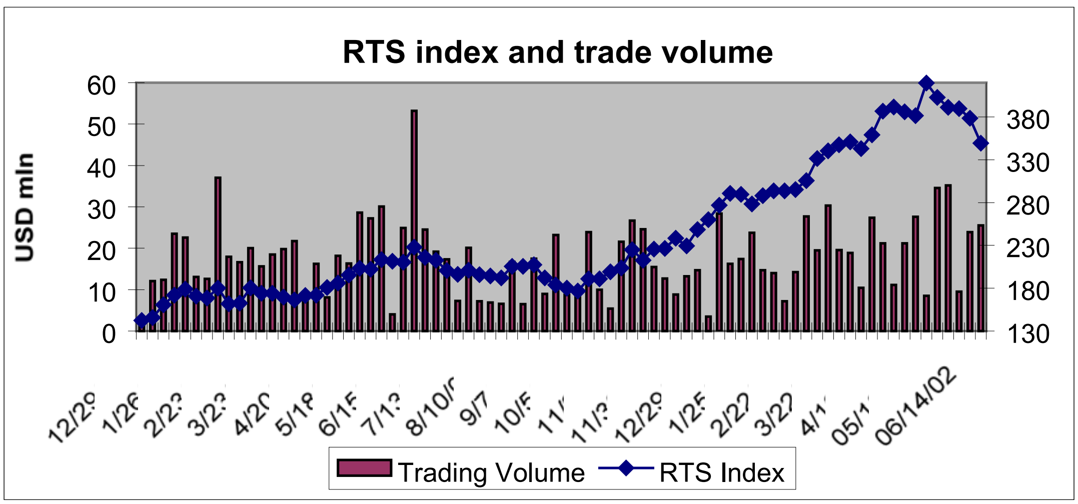


Stock Market

RTS has experienced a 5-week downturn and finished last week slightly below 350. The last time the market traded on that level was the beginning of April. In early June the market resisted successfully negative news from the world markets, but last week resistance was broken and aggressive selling prevailed throughout the week, touching both blue chips and second tier stocks. News about continuous falls in world markets triggered stock dumping. Average trade volumes increased by 83% last week.



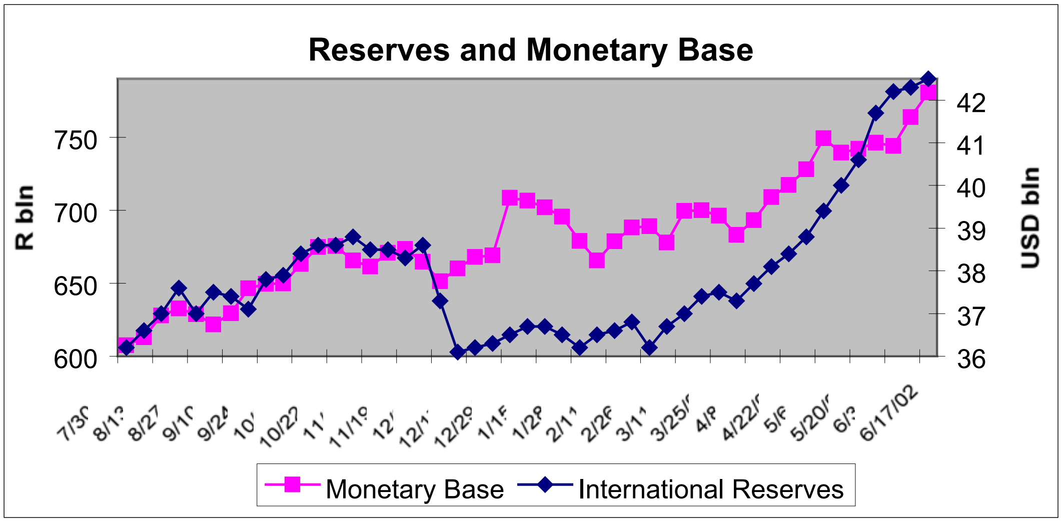




International Reserves and Monetary Base

During the first week of June, international reserves grew by $500 million and reached $42.2 billion. Such rapid growth is worrisome, as it is happening in conjunction with additional ruble issuance. Many suspect that increased inflation last month is partially due to high reserve accumulation. During the following weeks, the growth in reserves slowed to $100 million and $200 million respectively to $42.5 billion. The Government and CBR then announced that they consider the existing level of reserves to be appropriate.

The monetary base decreased by R2.2 billion during the first week of June and totaled R743.9 billion. However, during the following two weeks, base money exhibited two very sharp upward swings (R19.9 and R16.8 billion) and reached a new high of R780.6 billion, 10.18% higher than in the beginning of the year.



Reserves and Monetary Base
R bln
USD bln
600
650
700
750
36
37
38
39
40
41
42
6/17/02
Monetary Base
International Reserves

Russia's 2003 Budget Framework

The GOR approved its basic draft budget parameters last week. The draft is notable for its continuity – overall expenditures stay roughly the same as a percentage of GDP while non-interest expenditure rise, slightly compensated by lower interest costs. Revenues and therefore the surplus fall moderately. Even the feared 2003 debt spike seems barely noticeable thanks to some prepayment, reasonable growth and some real ruble appreciation. In fact, for a country supposedly in the middle of a dramatic program of structural and tax reform, the budget shows surprisingly little sign of these changes. This week we look at some of the assumptions underlying the new federal budget. (Budget numbers are at the end).

Macro assumptions -- There has been much discussion about the growth assumptions in the budget. Business leaders and oligarchs have criticized the assumptions as being too optimistic, especially in certain sectors, while the Prime Minister has been publicly at odds with his Finance Minster over whether they are optimistic enough. Though officially there is a range for forecast real growth of 3.4-4.4%, the budget numbers assume the higher figure. Finance Minster Kudrin has clearly been fighting, and apparently winning, the battle to keep the growth estimate down. With current growth, fixed investment and industrial production all hovering in the 3-4% range, there is little to support a big growth up-turn that would warrant a higher estimate.

Though the budget still assumes a reasonable surplus of 0.77%, the 2003 draft is moderately looser that this year's budget. Instead of building fiscal reserves, it spends them, albeit for external debt which will not add to liquidity. Still the fiscal loosening means that the sterilization burden will shift away from the fiscal side toward the monetary. This makes Russia's economy, especially inflation, even more vulnerable to higher-than-expected oil prices and the (otherwise positive) decline of capital flight. It also puts pressure on CBR to develop new tools to soak up liquidity, for example a bigger domestic debt market or a repo-loan window. All this makes the question of growth assumptions all the more key. If 2003 expenditures are based on overly optimistic assumptions, the GOR could well face the choice of having to cut spending in the run-up to Duma elections or tolerating significantly higher inflation. This is a postion Kudrin clearly doesn't want to be in.

The fiscal reserve – will it be there when they need it? -- Budget dynamics in 2003, more than in most years, rely on what happens in 2002. This is because the GOR is counting on using the accumulated fiscal reserve to cover almost half of its $10.8 billion of external financing costs. Minfin began 2002 with R88 billion in unallocated reserves on account at the CBR. The forecast for this year was that these would grow by R110 over the course of 2002 to almost R200 billion. Then, in 2003, these funds would be drawn down nearly completely (by R179 billion) for external debt repayment. The problem right now, almost half way through the year, is that fiscal reserves stand at only R35 billion (as of June 1) after oil prices stayed significantly below the $23.5/barrel assumed in the budget. The dip is not entirely unexpected due to the seasonal pattern of revenues and expenditures and the fact that revenues are booked on a cash basis while expenditures are recorded as soon as they are credited to the ministries accounts. Still the low current level of the reserve and its so far failure to rebound make the fiscal reserve assumption very tenuous.

There are other factors that may hold down surpluses in 2002 and thus what is available in the reserve for 2003. Assumed in the 2002 budget was the assumption that if revenues came in low, as they currently are doing, then designated expenditures of up to R68 billion would be cut to compensate. Several weeks ago, however, the Duma passed a supplementary military wage increase at a cost of R39 billion in 2002 with no compensating cuts. The assumption is that R20 billion would be taken from the contingent funds (which likely would be cut anyway) and the rest would be compensated by lower debt service resulting from a weaker dollar (saving which also otherwise would have gone to the fiscal reserve). In essence, the fiscal reserve thus is diminished by the full R39 billion.

None of this may be all that dire. There remains the possibility of issuing eurobonds to cover any financing gap and a $1 billion eurobond in 2003 seems relatively likely at this point. Up to $2 billion in eurobonds originally forecast for 2002 could also be issued later this year, though the desirability of this would depend on the external environment, currently not looking very positive. It is also worth noting that the whole concept of a fiscal reserve is not very important from an economic perspective. When Minfin deposits surplus funds at the CBR, there is no economic difference between holding the funds in a separate account or repaying part of Minfin's existing debt to CBR. Likewise, there is no economic difference between drawing down the reserve fund and simply borrowing from the CBR. Where it does matter is in the budget code and in public perception. Surpluses are more politically palatable and marginally more defendable from Duma spenders when they are shown in a tangible account designated for a specific purpose like debt repayment.

Taxes -- The budget contemplates several tax changes, but most of the assumed fiscal impact comes from the R165 billion that regional road funds lose when the final 1% turnover tax is repealed. Compensation for this will come primarily from reducing the federal portion of the profits tax from 7.5% to 3.5% (out of a total of 24%) netting R121 billion. Some compensation will also come from a 45% rise in the gasoline tax, some of which accrues to the regions, and from an increase in the cigarette tax. This however still leaves the regions R25-35 billion short something that is sure to be actively debated in the fall.

Surprisingly, the most significant piece of tax legislation this year, the new small business tax, incurs only very minor revenue effects (less than R5 billion on the federal level). Part of this reflects the uncertainty of the law's final form, but also is a function of how difficult it is to predict taxpayer behavior in parts of the economy, like SMEs, with high levels of tax avoidance. Overall, tax compliance is assumed to stay at its current 92.2% level (this, of course, doesn't include the vast gray economy that isn't even part of the tax system), but R21 billion of tax arrears are assumed to be filled.

Spending - The budget's spending priorities will be easier to determine in subsequent, more detailed drafts of the budget. Still, at first glance, it appears that there are relatively few palaces where the fiscal costs of structural reforms are obvious. Military spending does not show a big jump to account for higher pay and the costs of downsizing and professionalizing the armed forces. There are some assumptions for the transfer to a system of targeted direct subsidies rather than exemptions, but no big changes in the judicial or civil service areas that might reflect bolder reforms.

Summary of 2003 Budget Assumptions

Assumptions	2003 Budget (draft)	%of GDP	2002 Budget law	%of GDP
Real GDP Growth	4.40%		4.3%	
Avg Exchange rate (R/$)	33.7		31.5	
Inflation	10-12%		14%	
Oil (Urals $/barrel)	21.5		23.5	
GDP (R Bil)	12850		10950	
Expenditures (R Bil)	2271.2	17.7%	1947.4	17.8%
W/out social fund (1)	1921.1	15.0%	1666.1	15.2%
Interest	276.7	2.2%	284.7	2.6%
External	220	1.7%	226.8	2.1%
Domestic	56.7	0.4%	57.9	0.5%
Non-interest	1994.5	15.5%	1662.7	15.2%
W/out social fund (1)	1644.4	12.8%	1381.4	12.6%
Revenues	2370.3	18.4%	2077.1	19.0%
W/out social tax (1)	2020.2	15.7%	1795.8	16.4%
Primary Surplus	375.8	2.9%	414.4	3.8%
Overall surplus	99.1	0.8%	129.7	1.2%
External Debt repayment ($)	17.3	4.5%	14.1	4.0%
Interest	6.5	1.7%	7.4	2.1%
Principal	10.8	2.8%	6.7	1.9%
Foreign Debt Financing ($ billion)				
Surplus	2.9	0.8%	4.13	1.2%
Draw on Fiscal Reserve	5.3	1.4%	0	0.0%
Privatization	1.8	0.5%	1.48	0.4%
Net domestic borrowing	0.4	0.1%	0.32	0.1%
Gold sales	0.3	0.1%	0.69	0.2%
Tied credits		0.0%		0.0%
Eurobonds ($ bil)		0.0%		0.0%
Total Financing	10.8	2.8%	6.6	1.9%
Financing gap	0.0	0.0%	0.1	0.0%

(1) Starting in 2002 half of social fund revenues are collected as taxes and counted as budget revenues. The full amount of these revenues (R281.3 billion in 2002 and R350 billion in 2003) are then expended into the pension fund.

EXPLANATORY NOTES

1. **EXCHANGE RATES**: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). MICEX Unified Trading Session (UTS) is the one in which exporters have to sell 50% of the repatriated currency. UTS fix (rounded) becomes the "official" ruble rate for the next day. "$-tod" price is the price of the dollar with same day delivery. "$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each of the dollar instruments is $100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. **INTEREST RATES**: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. **STOCK INDICES**: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. **INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION** represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. **MONETARY BASE** (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. **LOMBARD CREDITS**, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.